PERS - PUBLIC AGENCY COALITION (PAC)

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THE ALERT

OCTOBER 15, 2017

Pay it Down Faster?

There's another big conversation afoot at CalPERS about employer contribution requirements. CalPERS actuaries are asking the CalPERS Board to reconsider how it calculates payments on unfunded pension liabilities. Even though this discussion gets very technical very quickly, we encourage you to try to wade through the issue so you can let your voice be heard while there is an opportunity to shape the policy. This conversation isn't just about what's best for the pension fund, but also about what makes the most financial sense for participating employers.

We'll do our best to make this as simple as possible, with the goal of allowing you to weigh the pros and cons of the proposed changes.

Amortization Policies

In 2013, CalPERS adopted its current smoothing and amortization method. Whenever there is a gain or loss to the plan, like the annual fluctuation in investment returns, CalPERS actuaries stretch the repayment of the loss (or gain) over a 30-year period. That is what's known as amortization. CalPERS currently utilizes a 5-year ramp up period, so whatever the additional contribution/credit might be required from the employer to make up for the loss, 20 percent of that amount is phased-in in year one, 40 percent in year two, continuing until 100 percent of the amount is factored into the employer rate beginning in year five. The purpose of the 5-year ramp up is to avoid significant volatility in employer contribution requirements.

The downside of this policy is that it creates what actuaries call 'negative amortization.' Stick with us, because this is the big problem all of this is meant to solve. Negative amortization basically means that an employer isn't paying enough money in a given year to even keep up with interest payments. In simplistic terms, it's like paying the minimum payment on a credit card bill, with the balance due continuing to grow despite the fact that you're sending the bank money each month.

Actuarial Policy Objectives

Actuarial policies are generally designed to balance a handful of key, often competing, objectives:

- *Benefit security* – The principal goal is to ensure future contributions along with current plan assets are sufficient to provide for all benefits expected to be paid to members and their beneficiaries.
- *Stable rates* – Avoiding large swings in employer contribution rates allows employers greater opportunity to budget for pension obligations, generally putting less strain on budgets. This objective is why CalPERS has historically gravitated toward longer smoothing periods for notoriously volatile investment gains and losses.
- *Intergenerational equity* – Benefits an employee earns during retirement should be paid for during the course of the employee's career. If employees work a 20-year career on average, for example, then a 30-year amortization policy would seem to push an employee's benefit obligations onto a future workforce. This is also one of the main reasons the Legislature has banned retroactive benefit enhancements. It's impossible to ensure intergenerational equity when benefits are granted for service already earned. Negative amortization is also a sign that this goal is not being met.

If payments are less than the interest due, then those liabilities are definitely being shifted to future generations.

- *Affordability* – In addition to creating stable rates, actuaries factor in a few other items that may impact an employer's ability to continue funding pension obligations. For CalPERS, those considerations include the impact on the estimated average employer contribution rate and the likelihood of high levels of employer contribution rates in any given year. Everyone understands that a contribution requirement of 50 percent of pay is likely to create a budget problem, and the actuaries have long sought to avoid such a scenario. However, with uncomfortably low plan funding levels, this seems to have been the first objective to be downgraded in priority.

The current CalPERS amortization and smoothing policy was adopted with the goal of creating stable rates, which was among the highest priorities for employers at the time the policy was adopted. However, with the negative amortization that the policy has created, CalPERS' actuarial team believe the policy needs to be revisited. Negative amortization means the goals of intergenerational equity and funded status are probably not being adequately factored into the equation.

History of Smoothing & Best Practices

When public plan actuaries discuss actuarial policies, we usually hear about both smoothing and amortization policies. Smoothing refers to the treatment of investment gains and losses in particular, the most significant contributor to employer contribution volatility by far. While investment returns will always be volatile, the hope is that they average out to the assumed rate of return over time. Smoothing of those returns is meant to create some stability by blending the win/loss ratio over a number of years.

For a long period of time, CalPERS used a 5-year smoothing policy. When employers took issue with the volatility of employer contribution rates driven by large swings in investment returns, CalPERS actuaries studied the issue and decided a 15-year smoothing policy would better to meet the goal of creating stable employer contribution rates while preserving the other objectives. At the time, CalPERS was the only public fund to utilize such a long smoothing period.

Then, in 2013, CalPERS created a new smoothing and amortization policy, partially in response to the new GASB pension reporting rules. When CalPERS created the new policy, it did away with the smoothing of asset values in the traditional sense. CalPERS' 15-year asset smoothing policy was creating too much of a divergence between the actual market value of assets and the 'actuarial value of assets' – meaning the value that actuaries were 'recognizing' at that point in time and then factoring in the long smoothing period.

Because of the problem this created with GASB standards, CalPERS actuaries developed its current policy. Under a traditional 5-year smoothing policy, if the fund experiences a $10 million loss, a $2 million loss is 'recognized' each year and factored into employer rates using an amortization policy. Under CalPERS' current policy, the whole $10 million loss is 'recognized' the first year and amortized accordingly, but because the resulting employer contribution increase would be too dramatic of a change, the rate increase is ramped up (or factored in) over 5 years. It creates a very similar net effect to 5-year smoothing, it's just more confusing for a layperson (like us). On the upside, for actuarial and accountant types, it creates more transparency because the plan's books always reflect the market value of assets (and avoids GASB reporting problems).

For this reason, the 5-year ramp up on the amortization of investment gains and losses is most likely staying. While all other aspects of the amortization policy seem to be on the table, this part of it will not change.

Recommendations & Potential Changes

20-year Amortization

CalPERS actuaries would like the Board to shorten its 30-year amortization policy, possibly to 20-years (at least 20 years is the number that's been most often floated for discussion). The primary reason to make this change is to address the problem in the current policy of negative amortization and the high long-term costs – it's bad

for the system's funded status and bad for employers.

While this would mean higher employer contribution rates, there's an upside for employers too. A shorter amortization period means significant savings in interest payments over the long term. Actuaries provided the example of a 30-year mortgage on a $1 million loan. Over 15 years, it would take $1.6 million to pay off the loan, versus $2.3 million if paid off over 30 years.

While an employer can already choose this shorter financing term (amortization schedule), few have requested it. Instead, those employers taking proactive action have primarily chosen to pay down their unfunded liability with an extra lump sum payment. About 22 percent of employers have made some sort of an ad hoc payment between July 1, 2012 to the present, some prodded by CalPERS' encouragement to take such action.

Ad hoc payments are definitely helpful, but perhaps not to the same degree as a reduction in the amortization schedule might be. Assuming all other factors remain the same, in repaying a $1 million investment loss, it would take an additional $385,000 ad hoc payment in year one to create the same savings as moving from a 30-year amortization policy to a 20-year amortization policy. That's a significant difference. It means paying off more than a third of the initial liability in the first year to generate the same degree of long-term savings. And knowing that at some point during the life of the 'loan' your balance will be growing despite your escalating annual payments (the negative amortization to which we refer), you can start to see why an employer might benefit from a shift in the way CalPERS bills for these liabilities.

But can you afford this? That's a very important question, and one the CalPERS Board would like to have answered. CalPERS actuaries say they will mitigate the impact of this change by applying it on a prospective basis only. That means all of your existing liabilities will continue to be amortized as they are, creating no immediate difference in employer contribution rates. The increase would be phased in over time as new gains or losses are added to the books.

CalPERS Chief Actuary Scott Terando says that if some years there are gains and some years there are losses, hopefully the gains and losses will offset each other over time to minimize the effect of the new policy. At least that's the way it should work if investment gains and losses come in as the actuaries expect. In reality, we all know there have been more losses than gains in recent history (especially factoring in the increased liability from assumption changes to mortality rates and discount rate reductions), so we're not sure how likely a scenario that actually is.

In any case, there would be a gradual transition to the new policy so any resulting rate increases should not be dramatic. The problem is that these modest increases will be in additional to your already-scheduled rate increases, and the total cost burden is the issue that needs to be considered. Would this extra amount be the bit that breaks the bank? Or would this gradual, systematic method of addressing negative amortization be a helpful financing tool?

Interestingly, in the same year that the CalPERS Board adopted its most recent version of the 30-year amortization policy, its former Chief Actuary signed off on a best practices document created by the California Actuarial Advisory Panel, on which he served as chair.[1] This panel of experts created by the State Legislature decided in 2013 that the model practice for public pension plans is to balance the needs for intergenerational equity and stable rates, resulting in an ideal amortization period between 15 and 20 years. Longer than 20 years, the report concludes, results in negative amortization beginning in years 16 to 18 for most combinations of assumptions. [2]

The Government Finance Officers' Association has also concluded in its best practices that amortization periods should never exceed 25 years, but ideally fall in the 15 to 20-year range.[3] Scott Terando, CalPERS current chief actuary, told the CalPERS Board that best practices do not support the policy that CalPERS currently utilizes because of the negative amortization that results. CalPERS actuaries want to make sure they're perform-

ing their duties with due diligence. And while the Board is extremely sensitive to the potential impact on employer rates, it's not clear how comfortable the Board will be ignoring actuarial standards to hold the line on unfunded liability contributions. Phasing the changes in on a prospective basis (as proposed) may be the fairest compromise.

5-year Ramp Up/Down

As we mentioned, the 5-year phasing in of increased employer contributions due to investment gains or losses, called the ramp up, isn't going anywhere. However, CalPERS actuaries would like to make some changes to the rest of its policy in this area.

First, actuaries would like to eliminate the 5-year ramp down, the gradual phasing out of rates, during the last 5 years of the amortization period. Actuaries say there is a more sophisticated way of dealing with sudden changes in the contribution requirements at the tail end of an amortization period. Because each gain or loss is amortized as it is placed on the books, actuaries say they can, for example, combine successive gains and losses at some point during the amortization schedule, eliminating the need for a ramp down to control rate volatility at the tail end of an amortization period.

As for the 5-year ramp-up, actuaries would like to eliminate this phase-in period for all other gains and losses besides investments. The benefit of phasing in the rate changes for gains and losses other than investments may not outweigh the resulting increase in costs. And again, if this change were adopted, it would be on a prospective basis only. This would mean a bigger jump in rates when losses are posted, but in general, most losses due to assumption changes or the like are not nearly as significant as investment gains or losses.

Level Percent of Pay

The last item may or may not be part of staff recommendations next month, as CalPERS' actuaries are still analyzing the potential impact on employers, but employer feedback on this item is still welcome, so we'll do our best to lay it out for you.

Like most public funds, CalPERS calculates amortization payments using a 'level percent of payroll'. That means because payroll is expected to grow by 3 percent each year (according to actuarial assumptions), the actual payments required by employers also increase by 3 percent each year over time. It's meant to keep a payment at a stable 2 percent of payroll, for example, but it doesn't quite work out this way if the payroll isn't increasing at the expected rate (like many employers in recent years).

In contrast, some public funds amortize unfunded liabilities as a level dollar amount, meaning the same dollar amount is charged over the course of the amortization period, just like a standard home mortgage. The debate is whether CalPERS should move to amortizing gains and losses from a level percent of payroll to a level dollar amount. This may seem minor, but it's not.

For example, the annual payment for a $1 million loss would be about $78,000 annually over 30 years using a level dollar amount, equaling a $2.3 million repayment over the course of 30 years. On the other hand, using the level payroll method (the current policy) means the payments would start at about $58,000, growing 3 percent each year to about $135,000 by year 30. Not only are the payments significantly higher towards the latter half of the amortization period, but the total repayment amount would be $2.7 million -- $400,000 higher than the level dollar method.

In recent years, CalPERS has shifted from expressing (and billing) unfunded liabilities as a percent of pay to a specific dollar amount. And that's why, no matter what you seem to do, your unfunded liability inches up another 3 percent each year. It can feel like a losing battle. Shifting to an amortization schedule using a level dollar amount would not only eliminate that annual escalation, but it would save money over the long term.

The down side? We're guessing you already know the answer… higher contributions over the short-term, at least with respect to any new unfunded liability that arises. With the level dollar amount method, any loss will result in a bigger jolt to employer contributions in the first year its recognized, undoing some of the progress

that's been made in reducing the volatility of employer rates. Actuaries are also concerned that all three of these changes combined could prove to be too much if we were to face another dramatic event – say a 20 percent drop in market value in a single year. (While this explanation has focused on the impact of amortizing a loss, it should be noted that this change would also apply to the amortization of gains.)

Sample Scenario

While it's not possible to provide data on the potential impact of these policy changes on a wide variety of public agency plans, CalPERS actuaries provided us with one hypothetical scenario which at least provides a rough illustration of the general magnitude of these proposed changes.

Let's say investment returns fall 5 percent below expected returns in a single year. The scenario below illustrates the impact of a shorter amortization period on required contributions for a 70 percent funded sample plan.

Agency X:
Plan assets - $70,000,000
Accrued Liability - $100,000,000
Unfunded Accrued Liability (UAL) - $30,000,000
Next Year Required UAL Payment - $1,800,000 *(not a factor in the results below but it gives some perspective on the impact of the amortization policy)*

Impact of "5% below expected" asset return:

UAL Payment Increase Due to 5% Asset Loss	Current 30 years (5 year ramp up)	20 years (5 year ramp up)	20 years (5 year ramp up and level $ payments)
First year UAL payment increase	$46,000	$59,000	$77,000
UAL payment increase in fifth year	$260,000	$330,000	$380,000
Estimated interest savings due to policy changes		$2.2 million	$2.6 million

The Path Forward

The CalPERS Board was presented with this information during its September meeting, at which time they asked the staff to get together with the system's stakeholders and solicit feedback before bringing the proposed changes back for Board approval. Earlier this month, CalPERS staff discussed the proposed changes with employer representatives (the League of California, the California State Association of Counties (CSAC), the California Special Districts Association (CSDA)), and we're told this will also be an item of discussion at the CalPERS Employer Forum conference later this month, October 23 – 25 in Rancho Mirage.[4]

The CalPERS Board seems very interested in employer feedback and is well aware of the significant budgetary constraints employers already face. As one Board member noted last month, there are reasons so many people choose 30-year mortgages even though a 15-year mortgage is more cost effective over the long term; and given the financial status of many local agencies, staff needs to establish if there is consensus for this policy change among employers. It's not clear that the actuarial team has yet sold the Board on the need for reforming the amortization policy. While long-term savings is a selling point, there may not be enough emphasis being placed on the primary problem of negative amortization.

Hopefully you have the opportunity to talk with a CalPERS staff person at the employer conference, but if not, we're told that you are welcome to provide your feedback to CalPERS staff person David Teykaerts at (916)

795-2195 or at David.Teykaerts@calpers.ca.gov. The more employers CalPERS hears from, the better informed they'll be in charting the path forward.

The CalPERS Board is currently undertaking its lengthy Asset and Liability Management process, the results of which are the basis for the system's asset allocation and assumed rate of return on investments for several years ahead. The amortization policy is a key piece of the information the Board must consider during that process, so Scott Terando, CalPERS Chief Actuary, is pushing for a decision sooner rather than later on the potential change in amortization policy. In order to be included in that process, the Board will review the proposed amortization policy at its November meeting (with a second reading expected at its December meeting).

That means now is the time for you to weigh in. If you have any questions, feel free to shoot us an email at abrown@lawpolicy.com and we'll do our best to find answers.

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1. http://www.sco.ca.gov/Files-ARD/BudLeg/CAAP_Funding_Policies_w_letter.pdf
2. The panel created amortization period best practices based on the source of the gain/loss. For general gains and losses, the ideal is 15-20 years. For gains/losses stemming from changes in actuarial assumptions (which typically occurs every 3 years), 15-25 years would be adequate. And for plan amendments (an employer-selected benefit increase, for example), gains/losses should be amortized over a maximum of 15 years, the experts advise.
3. http://www.gfoa.org/investment-policies-defined-benefit-plans
4. Sign up at https://www.calpers.ca.gov/page/education-center/employer-education/educational-forum

PERS BITS

The Stats that Matter

During the Legislature's summer hearing on CalPERS' agencies at risk of default, CalPERS didn't have a full picture of the financial security of its participating public agencies, leaving some of the legislators' questions unanswered. Since then, CalPERS has been collecting data to try to form a clearer picture about how deep the problem goes and how many other agencies may be in line for benefit cuts.

CalPERS reports that there are 2,878 employers participating in the pension plan – including the State, 1,511 public agencies and 1,366 school districts.[1] Of those public agencies, 52 percent are special districts, but they represent just 16 percent of total public agency participants. The majority of public agency participants, 52 percent, are employed by cities or towns, which make up 30 percent of the total number of agencies. The average funded status of all public agency plans is currently 69 percent. Twenty-three agencies are over 100 percent funded, but 16 are less than 60 percent funded.

CalPERS has 167 joint power authorities (JPAs) and 63 non-profits participating in its pension program. You may recall that JPAs pose a special problem because they often include language shielding the member agencies from any liabilities. The Legislature wanted to know exactly how many of those JPAs could become a problem when they fold. CalPERS says only 9 of those JPAs have a financial obligation for pension benefit liabilities that revert back to the member agencies. While the Legislature may address this issue when it's back in session, for its part, CalPERS says it will seek a statutory change to require new JPA members to be jointly and severally liable for all of the JPA's pension obligations.

Staff also identified 59 inactive public agencies, 13 of which are JPAs. Inactive plans should be considered a red flag for possible defaults and/or termination. Staff told the Board that it is initiating conversations with these inactive agencies and would report back on its findings in December. It's curious that things have gotten to this stage of the game *without* a conversation having occurred.

Finally, CalPERS has received a notice of intent to terminate from 4 agencies: Alhambra Redevelopment Agency, Exposition Metro Line Construction Authority, California Redevelopment Association, and Herald Fire Protection District. If the termination liability amount is paid, then there's no significant risk for the benefits owed to

the employees of these agencies, but it's unknown at this point whether those termination liabilities will be met. CalPERS says it will also pursue legislation next year to establish timeframes for the termination process and to require employers to notify past and present employees of its intent to terminate so the impacted parties aren't the last to know. CalPERS' Chief Actuary noted that if an employer wants to terminate and has the money to do so, it's not good for either the employer or for CalPERS to require a one-year waiting period.

Isn't this Election Over Yet?

This year's CalPERS Board election has been a doozy. This is the first time that CalPERS has allowed online and telephonic member voting, taking these extra measures to increase voter turnout. At the end of the day, we're told that while members appreciated having easier methods to cast their votes, those efforts did not boost voter turnout. Approximately 121,000 members voted in this year's member-at-large election, compared to 138,000 votes the last time this particular election was held. Hats off to CalPERS for doing everything but stand on its head while performing a juggling act to get its members more engaged in its elections, but success on that particular goal seems to be elusive.

Incumbent elections are often a breeze, but not this year. Because CalPERS Board election rules require the winner to receive at least 50 percent of the vote, we're now headed to a runoff election between incumbent Michael Bilbrey and his challenger Margaret Brown, business services manager for the Garden Grove Unified School District. Bilbrey received 40.8 percent of the vote and Brown received 35.4 percent. Ballots for the runoff election will be mailed on November 10th.

Meanwhile, in the election for the vacant second board seat, David Miller, former president of the California Association of Professional Scientists, won 63.7 percent of the votes compared to 36.3 percent for former CalPERS board member Michael Flaherman. This is the fourth time Miller has run for the CalPERS Board, proving once again that, sometimes, persistence pays.

While we may want to put that half of the election to rest, that might not be possible. Speaking before the CalPERS board during the public comment period at its September meetings, Michael Flaherman stated that there are significant problems with the election. He accused staff of attempting "to waiver on some constitutional issues," specifically pointing to a provision in the constitution that requires elections to be conducted by secret ballots. Flaherman suggested that Board rules requiring members to sign their ballots means that candidates can see voter signatures if present during a ballot count or by accessing those ballots when they're placed in state archive storage.

Flaherman said that staff also misled the CalPERS Board and the public about the vendor it chose to administer the elections. The company, Integrity Voting Systems, was touted by staff as being certified by the Secretary of State. Flaherman says the company is certified for printing ballots, not for conducting the election procedures utilized by CalPERS. That distinction, Flaherman argues, seems intentionally misleading. He might have a point about incomplete staff work, but is that enough to invalidate election results? Is that proof that the vendor is incompetent? We think not.

We haven't heard anything further on this matter, but consider this a forewarning that all may not be settled. We may end up with a contested election on our hands. Of course, these procedural election issues could have been raised by Flaherman back in March, before the ballots were distributed, but that wouldn't have served his agenda in quite the same way. You may recall that earlier this year we mentioned that having Flaherman on the Board again was likely to stir up conflict…

CalPERS put together a fact sheet in response to all of the concerns raised, so if you share any of these concerns or would like to learn more, check it out at: https://www.calpers.ca.gov/docs/board-election-process.pdf.

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CalPERS Investing in Trump?

Last month a representative for two organizations called the Free Speech for People and Courage Campaign called the CalPERS Board to task for its investment in a New York City development called Trump SoHo. Trump SoHo is funded in part by a private equity fund known as CIM Fund III, of which CalPERS is a member, allegedly putting forward 30 percent of the fund's capital.

Donald Trump's business holdings and potential for conflicts of interest have been an unending source of conflict since even before he took office. There's a provision in the constitution called the domestic emoluments clause (we had to Google it) which basically prohibits any office holder from accepting kick-back or swag from a "king, prince, or foreign state."

The idea is to prevent an individual from being corrupted by foreign powers, but this provision is not clear cut. There has been no legal challenge nor court ruling providing clarification about what exactly this provision means or to whom it applies. Many political pundits argue the clause is a broad anti-bribery clause and would apply to Trump's business interests. Others have questioned whether this rule even applies to the office of the president. Assuming it does, Free Speech for People and Courage Campaign called on CalPERS to stop enabling Trump to violate the emoluments clause by financially backing his questionable business interests.

CalPERS CEO Marcie Frost responded in writing, specifying that CalPERS is a limited partner in a commingled fund, subject to investment terms and conditions. As such, CalPERS is unable to unilaterally impose its own judgement or direction onto CIM Fund III decisions or its contractual obligations. Meanwhile, Frost writes, "We expect that CIM will manage the property in the best interest of its investors and our members…"

Just a few weeks later this particular property became the focus of national media attention once again with the Manhattan District Attorney's office coming under fire for dropping criminal charges against Donald Trump Jr. and Ivanka Trump in connection with this property. It was alleged that criminal charges were dropped after Trump's personal attorney, who had no previous involvement in the case and who also happened to be a large campaign contributor, paid a visit to the district attorney. Charges were dropped despite the fact that investigators were on the verge of bringing an indictment on federal fraud charges and the Trump team was "floating the possibility of a settlement."[2] (Check out the article link in the footnotes – it's an interesting read, if you haven't already seen it.)

The Trump SoHo controversy is not going away, with the building reportedly being examined by special Counsel Robert Mueller along with other Trump family business dealings. Although the property changed hands in 2014 following foreclosure, the Trumps still have a role its ongoing sales and operations. And this is one perfect example of how a pension fund trying to stay squeaky clean can nevertheless find itself in the middle of a controversy.

New CFO

CalPERS recently named Charles Asubonten as its new chief financial officer (CFO) to oversee all its financial and risk management programs. With an increasing number of functions being brought under the 'finance' umbrella within CalPERS, these are big shoes to fill, and Charles will have a prominent role in many issues of concern to public agencies participating in CalPERS.

Most recently, Asubonten was the managing director in a private equity firm. Over the course of his career he has served as a chief financial officer, group controller, finance director, treasury analyst, auditor and accountant. He holds an MBA from the University of Michigan, and is a Certified Public Accountant and a Chartered Financial Analyst. The credentials are there. Now we get to see where his new leadership will steer the organization.

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1. https://www.calpers.ca.gov/docs/board-agendas/201709/financeadmin/item-6a-01.pdf
2. https://www.newyorker.com/news/news-desk/how-ivanka-trump-and-donald-trump-jr-avoided-a-criminal-indictment/amp